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PARTNERS

INVESTMENT UPDATE

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We wish our clients and readership a Happy New Year.

December so often provides some end-of-year cheer with a Santa Claus rally in stocks as trading volumes thin down and investment managers chase portfolio returns to bolster their books and incentive schemes at year end. 2022 offered no such cheer, instead markets continued their downward reset which has been the feature of the annus horribilis for owners of real assets. We remain somewhat philosophical about the trajectory of markets and the word “reset” does seem highly appropriate. A reset from the excess of quantitative easing and the “everything rally” that provided relatively easy returns over the past few years and ballooned valuations to successive new highs.

In fact, a so-called Santa Claus rally did appear to be on the cards early in the month as US stocks had begun an ascent towards the important 200-day moving average with some apparent conviction and at one point did very briefly surpass the psychologically important milestone. However, in a replay of August’s price action, the oxygen of ongoing investment support above the 200-day moving average proved too thin to sustain stocks and they quickly fell away again. Our chart below annotates the story.

Source: *Investing.com as at December 2022*

Developed markets central bankers played the role of pantomime villains during December and whilst their messaging was important and instructive for the future path of markets the overall tone and hawkish delivery proved more than sufficient to snuff out any flicker of short-term market confidence that was underway. As we have stated here every month it seems, it is the defeat of inflation that remains the pre-eminent focus of central banks. It does seem they will not relent in their use of interest rates and other fiscal weapons until the dragon is slayed. In this regard there is some more encouraging news, at least from America and possibly from the UK.

US CPI inflation for November printed at a lower level than markets had forecast at 7.1%. and to replay our earlier view, it does appear the worst is behind us, and a downward trend is underway. We must remind ourselves inflation is a lagging indicator. US interest rates did rise again during the month, albeit by 0.5% rather than the previous rate of increase which has been 0.75% in successive months. We anticipate one or two further rises early this new year before a pause of several months and then a gradual pivot lower. Jerome Powell's categoric reaffirmation that his objective is to see inflation fall to the Federal Reserve target of 2% and he will not rest until this goal is achieved pushed markets lower, as stated earlier.

UK CPI inflation for November also printed slightly lower than had been forecast at 10.7% down from 11.1% in the previous month. It is possible domestic inflation has peaked too, although we feel less confident as industrial disputes across state owned employers rage on with pay demands at high levels. Fuel duty may be re-applied early in 2023 which will send inflation data higher again – so we remain tentatively optimistic at home. UK interest rates rose in line with US rates.

The news from Europe and Japan is different but equally important. Mrs Lagarde (Head of the ECB) delivered a combative speech. Out were previous dovish tones about inflation and in came hawkish commitments about raising interest rates and forcing inflation down from an apparently embedded 4% across the whole of the Eurozone. This has pushed up German bond yields to 2.5% and Italian yields likely to north of 5%. This disparity displays the relative weaker borrower status of Italy and their indebtedness and ability to service interest payments at higher levels brings some concern. Other economically weaker nations in the bloc are not immune.

Japan had been relatively successful in banishing inflation from her shores and had defended ultra-low borrowing costs by yield curve control strategies including the Bank of Japan (BOJ) effectively buying up issued government bonds. The policy has been broadly successful but with the BOJ now owning more than 50% of all issued government bonds, the market has become dysfunctional. Mr Kuroda, the soon to retire Head of the BOJ, announced the Bank

Unless otherwise stated all data sourced from Bloomberg as at December 2022 will allow bond yields to fluctuate +/-0.5% soon. This is important as it doubles the previous range and effectively sets the scene for Japanese borrowing costs to rise over time. This will also encourage active Japanese investors to keep their money at home to fund regeneration programmes, rather than investing abroad.

After domestic unrest across the vast country the Chinese Communist Party began to relax Covid lock down control tactics and vaccination roll outs. Covid-19 continues to sweep across the country with preventative measures not proving hugely successful although the virus is weakening. The unlocking of the economy is likely to happen in stages and demand for oil and industrial commodities remains relatively subdued.

Jerome Powell, Head of the Federal Reserve, spoke enthusiastically about an economic soft landing for the US economy. However, we are not alone in considering this an increasingly remote possibility. The US Conference Board leading indicator index has a 100% accuracy rate for anticipating recessions in America as shown below in a chart from one of our research partners. When the year-on-year change turns negative for 2 or more consecutive months the proximity of a recession is typically around 7 months distant.

Unless otherwise stated all data sourced from Bloomberg as at December 2022

This equates to a possible US recession during the early part of this year which will in turn encourage a pivot in interest rate policy. Good news for investors as markets move ahead of the fact! Meanwhile we do anticipate some company earnings being disrupted by falling demand provoked by the economic slowdown. Other corporates will continue to prosper as their goods and services are considered staples. Those goods and service providers towards the base of Maslow's hierarchy of needs pyramid are likely to fair the best.

At portfolio level we took the opportunity afforded by the most recent bear market rally to raise further cash levels across the range. Our short dated fixed income weightings will likely begin to perform well as the nearing interest rate zenith is reached. UK fixed income weightings buffered by the mini budget debacle recovered well, as expected. We do anticipate some early year volatility in equity markets linked to a possible downgrade in earnings expectations, linked with recession onset. If PE ratios register in the 14-15x earnings zone we are likely to be active buyers. Likewise, we expect to diversify our US dollar concentration in the approaching future. Longer dated bond yields remain correlated with equities adding further weight to our sentiment, although we anticipate this to revert to the traditional normal as monetary policy begins to ease.

Geopolitics has shaped 2022 and will remain the one notable aspect of global investment strategy that cannot be modelled. We expect the war in Ukraine to persist for some time yet as winter sets in, notwithstanding a momentous change of policy or leadership in Russia. China's over indebted property sector, shrinking population and faltering urban migration programme weighs on its ambition to become the dominant world economic leader. The West has begun to repatriate some manufacturing - all of which cumulatively may stimulate China to invade Taiwan to seize semiconductor knowhow and re-establish itself with its own people and the Pacific region. We maintain vigilant observation.

Markets have provided a considerable reset over the past year – looking ahead we anticipate a regime which is more normal, heralding conditions supportive of "back to long term investing". This is to be welcomed across the board and investor patience and strategic forethought will be well rewarded, of that we have little doubt.

Written by the Alpha Beta Partners Investment Team

CONTACT

Andrew Thompson

Tel: 020 8152 5117

Email: at@alphabetapartners.co.uk

Address: Northgate House, Upper Borough Walls, Bath BA1 1RG.

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